

Office of Chief Counsel
Internal Revenue Service
memorandum

CC:NER:BRK:TL-N-7581-98

TKerrigan

JAN 27 1999

date:

to: District Director, Brooklyn
Attention: Examination Division
Examination Branch I
Group 1123, E:E:F:1123

from: District Counsel
Brooklyn CC:NER:BRK

subject:

Taxable years [REDACTED] and [REDACTED]

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Reference is made to our memorandum dated December 1, 1998 in response to your request for advice concerning the proper sourcing of income from the sale of goods by the taxpayer to an unrelated domestic corporation. We stated in the memorandum that it was being referred to the National Office for review, that the review might result in modifications to the advice rendered therein, and that we would inform you of the results of the review.

The memorandum was reviewed by subject matter specialists in the National Office. We were notified that they concur with the advice rendered therein. If you have any questions or require additional information, please call Thomas Kerrigan at (516) 688-1702.

DONALD SCHWARTZ
District Counsel

By:

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Internal Revenue Service

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This memorandum is in reply to your request for advice, dated November 5, 1998, concerning the proper sourcing of income from the sale of goods by the taxpayer to an unrelated domestic corporation. In formulating our response, we have relied upon the supporting facts outlined by International Examiner Henry Peyser. The information submitted for our consideration is set forth below.

FACTS

The relevant facts, as we understand them to be, are as follows: [REDACTED], a wholly owned subsidiary of [REDACTED] is a wholesale distributor of [REDACTED] and [REDACTED] products in the United States manufactured by the parent company in [REDACTED]. On [REDACTED] entered into the first of a series of [REDACTED] "OEM Purchase Agreements" with [REDACTED]. Pursuant to these agreements the parties agreed that [REDACTED] would purchase various [REDACTED] and [REDACTED] from [REDACTED].

The delivery terms of the original [REDACTED] agreement and the subsequent [REDACTED] agreement, provided that, unless otherwise provided, all goods shipped under the agreements were to be shipped "F.O.B." [REDACTED]. The agreements further stated that title and risk of loss passed from [REDACTED] to [REDACTED] upon delivery to the "F.O.B." port. On [REDACTED] and [REDACTED], the parties entered into new agreements, which modified the delivery and shipment terms. Under the new agreements, the products were shipped "F.O.B." [REDACTED] designated port in [REDACTED]. The new agreements also provided that title and risk of loss passed to [REDACTED] upon receipt at the "F.O.B." delivery port. Based on these changes to the OEM purchase agreements, title now passes outside of the United States.

The taxpayer has always reported income from these sales as U.S. source income on their tax return. During the current audit cycle, the taxpayer raised the issue of the appropriate sourcing of this sales income. The taxpayer contends that the transactions at issue, which resulted in sales in the amount of \$[REDACTED] and \$[REDACTED] for the taxable years [REDACTED] and [REDACTED] respectively, should be sourced as sales outside the United States instead of sales from within the United States. Accordingly, the taxpayer has made an informal refund claim for the [REDACTED] and [REDACTED] tax years based upon the re-sourcing of this income from U.S. source to foreign source.

ISSUE

Whether income from the sale of goods by the taxpayer to an unrelated domestic corporation where title to the goods, pursuant to the terms of the purchase agreement pass outside of the United States, is properly sourced as foreign source sales income.

LEGAL ANALYSIS

I.R.C. § 901 allows a domestic corporation to claim a credit against its Federal income tax liability for foreign income taxes paid, accrued, or deemed paid. I.R.C. § 904 limits the amount of that credit to that proportion of the tax liability attributable to income from sources outside the United States. I.R.C. § 862 provides that income from sale of goods outside the United States will constitute income from sources outside the United States. Treas. Reg. § 1.861-7(c) adopts the general "title passage" rule that a sale of property takes place at the time when, and the place where, the rights, title, and interest of the seller in the property are transferred to the buyer. The regulation, however, supersedes the "title passage" rule in limited circumstances. If

a sale is arranged in a particular manner for the primary purpose of tax avoidance, the source of income from the sale is determined by the "substance of the sale" test as set forth in Treas. Reg. § 1.861-7(c).^{1/} In these instances, all facts and circumstances of the transaction, including negotiations, the execution of the agreement, the location of the property, and the place of payment, will be examined for purposes of determining the place where the substance of the sale occurred.

In the present case, the OEM agreements clearly specify the intent of the parties with respect to passage of title. Therefore, title passed to [REDACTED] upon the taxpayer's delivery of goods to the designated "F.O.B." port. All transactions under the terms of the third and fourth agreements, would be sufficient to transfer rights, title, and interest to the goods and would appear to constitute a sale in [REDACTED], within the meaning of Treas. Reg. § 1.861-7(c). See Liggett Group, Inc. v. Commissioner, T.C. Memo. 1990-18. In Liggett, sales from a United Kingdom liquor producer to a U.S. distributor who immediately re-sold the product to U.S. third parties were deemed to occur outside the United States. The Court determined that the parties intended the subsequent re-sale terms were "F.O.B." British Isles. Accordingly, title and risk of loss passed in England and the transactions produced income from sources outside the United States for I.R.C. 862(a)(6) purposes. We note, however, that the Service issued an action on decision in the Liggett case recommending nonacquiescence in this case because of the Service's concern that these types of transactions, (i.e. sales involving U.S. buyers and sellers, where the economic activities surrounding the sales take place in

^{1/} Treas. Reg. § 1.861-7 Sale of personal property.
(c) Country in which sold.

For the purposes of part I (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder, a sale of personal property is consummated at the time when, and the place where, the rights, title, and interest of the seller in the property are transferred to the buyer. Where bare legal title is retained by the seller, the sale shall be deemed to have occurred at the time and place of passage to the buyer of beneficial ownership and the risk of loss. However, in any case in which the sales transaction is arranged in a particular manner for the primary purpose of tax avoidance, the foregoing rules will not be applied. In such cases, all factors of the transaction, such as negotiations, the execution of the agreement, the location of the property, and the place of payment, will be considered, and the sale will be treated as having been consummated at the place where the substance of the sale occurred.

the United States and where the seller holds title to the goods outside the United States only momentarily), are "most likely arranged for tax avoidance purposes." Liggett Group, Inc. v. Commissioner, AOD CC-1991-03 (February 11, 1991).

Notwithstanding, the Service's contention that sales in the circumstances described in Liggett should produce U.S. source income, we believe that the facts developed in this case do not support even the inference that the transactions at issue were structured primarily for tax avoidance purposes. First, the place of sale will ordinarily be given effect for tax purposes so long as the agreements have a commercial purpose apart from the expected tax consequences and the title transfer was not a sham. See A.P. Green Export Company v. United States, 284 F.2d 383, 390 (Ct. Cl. 1960). In the present case, the taxpayer has represented that the changes to the OEM purchase agreements were made at the specific request of [REDACTED]. The taxpayer further alleges that [REDACTED] asked for the new passage of title language in order to negotiate more favorable shipping terms and to consolidate the shipment of these goods with other goods purchased from various [REDACTED] suppliers. Assuming that the taxpayer's representations are not controverted, these facts would establish a bona fide business purpose for the modification to the purchase agreements. Second, the handling of the shipments, after being delivered to the [REDACTED] delivery port, was consistent with the express intent of the modified agreements that title passed to [REDACTED] in [REDACTED]. [REDACTED] was the importer of record, arranged for shipment, contracted with a customs house broker for U.S. Customs clearance, and paid the applicable import taxes (including the I.R.C. § 4681 Ozone Depleting Chemicals Tax) for all shipments after [REDACTED].

Finally, the taxpayer has reported all income from these transactions, including amounts received under the third and fourth OEM purchase agreements, as income from sources within the United States. The taxpayer first raised the foreign sourcing issue during the [REDACTED] and [REDACTED] tax audit. The taxpayer alleges that the issue was first brought to the taxpayer's attention by its certified public accountant earlier this year. These facts and circumstances, which are favorable to the taxpayer, are potentially fatal to the development of any tax avoidance argument. As a practical matter, we note that the taxpayer has not yet received any tax benefit from these transactions.^{2/}

^{2/} The taxpayer has made an informal claim, which the international examiner estimates will result in a tax benefit of \$ [REDACTED] for the tax years at issue in the form of a foreign tax credit.

Furthermore, the taxpayer has failed to take advantage of the alleged tax avoidance benefit from these sales during any of the preceding tax years. The taxpayer's original reporting of these transactions for Federal income tax purposes effectively undercuts any tax avoidance argument since the taxpayer's conduct is simply inconsistent with an attempt to reduce its tax liability by transforming this United States income into income from outside the United States.

CONCLUSION

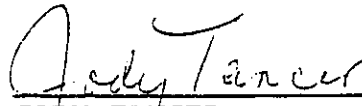
Under the revised OEM purchase agreements, dated [REDACTED] and [REDACTED], [REDACTED] acquired and transferred title to [REDACTED] in [REDACTED]. The Service has developed no facts establishing that sales at issue were arranged in this manner for the primary purpose of tax avoidance. Accordingly, income from these transactions represents sales income from sources outside the United States and should be sourced as such.

This opinion is based upon the facts set forth herein. It might change if the facts are determined to be incorrect. If the facts are determined to be incorrect, this opinion should not be relied upon. You should be aware that, under routine procedures which have been established for opinions of this type, we have referred this memorandum to the Office of Chief Counsel for review. That review might result in modifications to the conclusions herein. We will inform you of the result of the review as soon as we hear from that office. In the meantime, the conclusions reached in this opinion should be considered to be only preliminary.

If you have any questions or require additional information, please call Thomas Kerrigan at (516) 832-2401.

DONALD SCHWARTZ
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By:



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